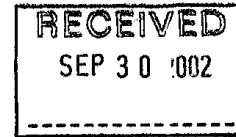




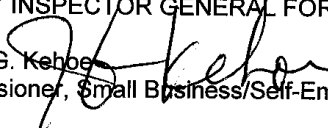
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224



SEP 24 2002

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Joseph G. Kehoe 
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Internal Revenue Service Should
Evaluate the Feasibility of Using Available Documents to
Verify Information Reported on Business Tax Returns
(Audit # 200230001)

The overall objective of your review was to evaluate the extent to which we use available financial data on information documents to verify what taxpayers reported on their business tax returns.

Banks and other financial institutions file information documents with the IRS for business and individual tax returns. As your report indicates, we routinely use information documents, such as Wage and Tax Statements (Forms W-2), to verify information taxpayers report on their U.S. Individual Income Tax Returns (Forms 1040). However, we do not routinely use this same information to verify information on business tax.

Over the past several years, we have taken steps to identify the business information we receive and to evaluate how we can use this information. We cannot implement your recommendations at this time. However, we believe our ongoing efforts will provide the results you hope to achieve. We ask for the opportunity to continue our efforts. Some examples of our efforts are:

- Business Master File (BMF) Information Returns Program (IRP) Study: In 1992 and 1993, the Examination and Collection Divisions conducted this study, which helped identify the types of business information documents we receive. We were unable to match documents as we planned because of problems with Employee Identification Numbers (EINs) and exempt organizations. In addition, the Collection Division could not use IRP information to identify delinquent returns.
- Business Information Database (BID): Although the BMF IRP Study did not yield the intended results, the Examination Division used this information to develop and test the BID to use for case building. The test ran from 1994

through 2000. The BID test was discontinued when the case building system was modernized with the Midwest Automated Compliance System (MACS).

- K-1 Matching Program: We have begun to match the information from taxpayers' Forms K-1 (Partner's Share of Income, Credits, Deductions, etc.) to their Forms 1040.
- Business Information Matching Program: We are performing limited matching on business tax returns. Included in the matching program are sole-proprietors who file a Form 1040 with a Profit or Loss from Business (Schedule C) using an EIN.
- SB/SE Research Project: SB/SE Research has started a project to see if we can use the IRP documents to identify delinquent returns Forms 1065 and 1120.

We cannot implement your recommendations at this time. The results of our current efforts, testing, and matching of business information documents, should resolve the issues raised in your report. We will continue to explore additional ways to identify and use all of the information reported to us. Based upon our history with this legislative proposal, we believe a legislative request requiring corporations to report corporate-to-corporate income transactions is not feasible at this time. I have outlined some concerns with your recommendations as follows:

- Automated Underreporter (AUR) Matching: The reporting requirements for businesses preclude AUR from successfully matching business documents. AUR does not have all of the information necessary to complete a proper match. Attempting to do so will result in the issuance of erroneous notices to a significant number of corporations thereby increasing burden and cost to those entities. If the existing laws were changed to require corporations to report corporate-to-corporate income transactions, AUR still could not match business information items. Generally, business information documents do not lend themselves to matching within the AUR system because the gross income on the corporate return contains combined items that the computer cannot match. In addition, income items such as cancellation of debt and currency transactions over \$10,000 would require a thorough review of the taxpayer's books and records to determine whether the items are taxable. AUR cannot work issues such as cash vs. accrual accounting and fiscal year filers as they are beyond the scope and grade level of the Tax Examiners.

We would encounter further problems when attempting to match dividends because the system is programmed to match the total amount of dividends reported. However, corporate rules allow for a dividend-received deduction. This enables corporations to reduce seventy percent of dividends received from other corporations with different percentages for various types of

dividends. This, too, would result in the issuance of thousands of erroneous notices due to corporations reporting lower dividend amounts.

- History of Legislative Proposal: The IRS and the Department of Treasury took the issue to Congress during the 1990's, when we sought a statutory change primarily to use the revenue from the proposal to offset certain losses from tax cuts. In the early 1990's, the Barnard House Subcommittee on Commerce, Consumer, and Monetary Affairs held hearings on Information Returns and how the IRS used them. In preparation for those hearings, the GAO did a number of studies on the possibility of using IRP documents for BMF purposes and testified in favor of establishing a program. Our BMF/IRP Study was in response to this GAO study. Commissioner Goldberg's position was that we should not use BMF/IRP unless we could ensure the information would be "timely, accurate, and useful." We determined the Commissioner's criteria would be met if we focused our efforts on certain payments for services over \$600.

In 1993, we got the proposal through the House as part of the Clinton Administration's budget package. It was called the "Service Industry Non-Compliance Initiative" or "SINC." The small business lobby then marshaled against the provision, and the Senate deleted it from the bill by a vote of 98-0. It was not restored in Conference. Because of the fate of the SINC proposal, we waited a few years before returning to Treasury with a new Initiative called the "Fairness in Information Reporting (FAIR) proposal." It was essentially a re-tooled SINC in which we addressed the issues opponents raised with the earlier proposal.

Despite a great deal of work with Treasury and Capitol Hill staff on this proposal, we were unable to include it in a legislative vehicle. Working with the GAO and the OMB, we changed the OMB procurement regulations to impose some BMF information reporting requirements on companies seeking federal contracts. The IRS continues to study using IRP documents for BMF purposes. However, a legislative request to impose information reporting requirements on businesses is probably futile now.

Our comments on the recommendations follow:

RECOMMENDATION 1

The Director, Compliance, SB/SE Division, should evaluate all information documents the IRS receives for businesses to determine if they can be used to increase business tax compliance.

ASSESSMENT OF CAUSE

We have a program to match information documents of individual taxpayers, but we do not have a similar program to match information documents for business taxpayers.

CORRECTIVE ACTION

We will continue to explore ways to use all information reported to us. However, even if legislative changes were made, problems outlined above reduce the probability of implementing a complete business matching program.

IMPLEMENTATION DATE

Not Applicable

RESPONSIBLE OFFICIAL

Director, Compliance, SB/SE Division

CORRECTIVE MONITORING PLAN

None

RECOMMENDATION 2

The Director, Compliance, SB/SE Division, should, based on the evaluation of business information documents, consider the feasibility of legislative changes to require the filing of additional information documents for corporations, where applicable.

ASSESSMENT OF CAUSE

The Internal Revenue Code exempts financial institutions from issuing some information documents to corporations.

CORRECTIVE ACTION

We will continue to identify and match the information we are receiving. However, recognizing the fate of the SINC and FAIR proposals, we believe a legislative request requiring corporations to report corporate-to-corporate income transactions is not feasible at this time.

IMPLEMENTATION DATE

Not Applicable

RESPONSIBLE OFFICIAL

Not Applicable

CORRECTIVE MONITORING PLAN

Not Applicable

If you have questions, please call me at (202) 622-0600 or Joseph Brimacombe, Deputy Director, Compliance Policy, Small Business/Self-Employed, at (202) 283-2200.